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E.O. 12958: DECL: 06/12/2026

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SUBJECT: CENTRAL BANK DIRECTOR'S VIEWS ON ECONOMIC AND
MONETARY POLICY DIRECTION

REF: CARACAS 01426

SUMMARY

¶1. (C) Central Bank (BCV) Director Armando Leon told EconOffs May 31 that, despite first quarter BCV cumulative operational losses of USD 136 million, the BCV would end May and June 2006 without losses, and was working with the Finance Ministry to mitigate anticipated BCV financial losses in July 2006 and beyond. (Note: These losses stem mainly from BCV operations to mop up excess liquidity. End Note.) He clarified recent press statement attributed to him that the BCV would not continue to transfer funds to the National Development Fund (FONDEN) as his own "personal view" and not a shift in policy. While acknowledging that low private sector investment and job creation remain problematic, he did not anticipate significant economic challenges in the near future and ruled out any macroeconomic policy adjustments next year (e.g. devaluation). Leon also argued that Chavez was pragmatic and would not further radicalize economic policies post December 2006. END SUMMARY.

BCV LOSSES

¶2. (C) According to Leon, after first quarter cumulative operational losses totaling USD 136 million (reftel), the Central Bank (BCV) would end May and June without losses. These losses stem mainly from the increasing cost of BCV efforts to contain monetary liquidity by issuing certificates of deposits (CDs). Money supply (M2, which equals currency, checking accounts, savings deposits, and CDs) grew 13.7 percent since January 2006, reaching USD 37.4 billion in May 2006, and the outstanding stock of BCV CDs was USD 15.5 billion as of March 2006. The loss to the BCV of interest income from the transfers of international reserves, totaling USD 10.2 billion to date to the National Development Fund (FONDEN), represented additional losses.

¶3. (U) To help shore up the BCV's finances, the Finance Ministry repaid an outstanding debt to the BCV of USD 315

million in May 2006, related to the 1990 debt refinancing. The Finance Ministry plans to repay part of this debt by transferring to the BCV fixed interest Bolivar-denominated bonds that expire in 2011 or 2012. Instead of issuing more BCV CDs, the BCV will resell the BRV bonds to local investors to withdraw some of the excess liquidity in the local economy.

¶4. (C) However, while the Finance Ministry assistance will provide the BCV short-term relief, Leon said that the BCV anticipated operational losses for July and beyond. According to Leon, many in the BCV attribute the BCV's current financial difficulties to the BRV's inability to execute its budget. Describing Venezuela's Treasury (at the Ministry of Finance) as one of the most modern technically in all of Latin American, Leon said that Venezuela is "first world with respect to financial management and fourth world with respect to budget execution.⁸ According to Leon, the Treasury transfers funds to the states, ministries, or public companies that do not have the capacity (or inclination) to spend immediately them. (Comment: The delay in budget execution is also related to widely-alleged corruption between some financial institutions and government offices that collude in parking money. End Comment.) The BRV has had the most problems executing budget in the areas of infrastructure, health, housing, education, and food, Leon said. He added that the BRV deposits funds in financial institutions, which in turn place the funds in the BCV. He estimated that about 40 percent of public expenditures come back to the BCV. (Comment: We are not entirely sure how Leon is calculating the 40 percent. Financial institutions could hold their funds (including BRV deposits) at the BCV to meet their legal reserve requirements, as amounts held in reserve

beyond the legal requirements, or to purchase BCV CDs. End Comment.) To address the BCV's long-term financial challenges, the BCV and BRV are coordinating BRV expenditure policy.

FONDEN

¶5. (C) Clarifying his remarks picked up in the press on May 26 that BCV would not transfer more funds to FONDEN, Leon said he was only expressing his personal view. (Note: Since July 2005, the BCV has transferred a reported USD 10 billion to FONDEN. End Note.) According to Leon, now that this initial transition period is over, FONDEN should receive its funding directly from PDVSA, which has been depositing roughly USD 100 million per week into the Fund. Leon claimed that BCV and PDVSA transfers to FONDEN have not had monetary impact. The BRV used FONDEN dollars to buy dollar-denominated Argentine bonds and sell them to banks in the local market. Leon does not agree with this practice, but is confident that it has no monetary impact because banks can earn more profit by selling the bonds overseas at the implicit exchange rate, than selling them locally. Therefore, these funds do not immediately enter the economy.

ECONOMIC PROSPECTS

¶6. (C) BRV officials have announced their goal to keep inflation at 10 percent or below for 2006. (Note: Inflation for May 2005 to May 2006 was 10.4 percent. Local analysts project that 2006 inflation could be 12 percent. End Note.) In Leon's opinion, this rate is higher than it should be, mostly due to increased public spending. According to Leon, the BRV has managed to keep down inflation with high imports and the BRV-supported Mercal supermarket chain. (Comment: High imports, made more affordable with an overvalued Bolivar, pressure domestic producers to maintain low prices. We estimate that the Bolivar is overvalued by approximately 20 percent. End Comment.) With competition from the BRV Mercal supermarket chain and price controls, private food companies cannot increase their prices for basic food staples

too much. Leon acknowledged that business can only accept pressures to push down prices to a point, before they will not produce. The BCV is surveying the business sector for its impressions of the economy and to determine the sustainability of the BRV policies.

17. (C) Leon acknowledged some challenges such as low private sector investment and unemployment, but argued that they are manageable. Despite strong economic growth (9.4 percent in first quarter 2006), Leon noted that the construction and communications sectors are the only sectors showing significant job growth, while the manufacturing sector has seen no job growth. From first quarter 2005 to first quarter 2006, the construction sector grew 21.2 percent, communications grew 28.1 percent, and manufacturing grew 9.4 percent. Leon wryly noted that the government had been &too neoliberal⁸ with respect to expected job growth, by assuming that general economic growth would fix the unemployment problem. (Comment: Notwithstanding the raft of retrograde economic policies the BRV has implemented to date. End Comment.) Leon discounted the possibility of an economic adjustment (read: devaluation) in 2007. (Note: This is contrary to almost all financial sector analysts. End Note.)

POST-ELECTION POLICY DIRECTION

18. (C) Leon expected strong continuity in BRV economic policy direction following the presidential election in December 2006. Unlike other financial sector contacts, Leon maintained that (a re-elected) Chavez would not push for an

increased State role in the economy, largely because the State did not have the inherent capacity to deliver jobs and services. For example, the government ultimately hired private companies to repave Caracas streets, after this work was delayed by over a year to try to hire public companies. Leon also said that private companies were ultimately hired to improve the Caracas airport when public companies failed. Describing Chavez as pragmatic, Leon said that Chavez has seen that increasing the State role doesn't work. Leon also attributed the BRV's economic vision directly to President Chavez.

COMMENT

19. (C) Leon appears to be independent in his views, but pragmatic and cautious in his criticism of BRV economic policies. While Leon believes that Chavez will not further radicalize economic policies after the presidential election, we note that Chavez has already built a legal framework and restructured public institutions to fence in the private sector. We do not doubt that Chavez would crack down further, if challenged.

WHITAKER